

Message Text

LIMITED OFFICIAL USE

PAGE 01 HONG K 01370 01 OF 02 061007Z

11

ACTION EA-09

INFO OCT-01 ISO-00 SP-02 AID-05 EB-07 NSC-05 CIEP-01

TRSE-00 SS-15 STR-04 OMB-01 CEA-01 CIAE-00 COME-00

FRB-03 INR-07 NSAE-00 USIA-06 XMB-02 OPIC-03 LAB-04

SIL-01 PA-01 PRS-01 AGR-05 /084 W

----- 083227

R 060748Z FEB 76

FM AMCONSUL HONG KONG

TO SECSTATE WASHDC 9020

LIMITED OFFICIAL USE SECTION 1 OF 2 HONG KONG 1370

E.O. 11652: N/A

TAGS: EFIN, HK

SUBJECT: PROJECTIONS FOR 1976-1977 HONG KONG BUDGET

REF: 75 HONG KONG 2098

SUMMARY: HONG KONG'S BUDGET IS CURRENTLY REGISTERING A SIGNIFICANT DEFICIT FOR THE SECOND CONSECUTIVE TIME. THIS RAISES A NUMBER OF QUESTIONS REGARDING THE GOVERNMENT'S FUTURE APPROACH TO BUDGETARY POLICY.

BASED ON PROJECTIONS FOUND IN FINANCIAL SECRETARY PHILIP HADDON-CAVE'S SPEECHES, SPECULATION ON THE SUBJECT OF TAX INCREASES HAS ARISEN IN FINANCIAL CIRCLES. HADDON-CAVE IS HONG KONG'S KEY ECONOMIC DECISION MAKER, AND HIS REMARKS REFLECT PROBABLE TRENDS IN BUDGETARY POLICY. IT IS LIKELY THAT MORE TAX INCREASES WILL BE INTRODUCED IN THE 1976-77 BUDGET SPEECH. END SUMMARY.

1. BACKGROUND: HONG KONG HAS TRADITIONALLY ADHERED TO A POLICY OF LAISSEZ-FAIRE, AND WITHIN THIS TRADITION, GOVERNMENT SPENDING HAS ACCOUNTED FOR A RELATIVELY SMALL PERCENTAGE (18 PERCENT) OF GROSS DOMESTIC PRODUCT. WITH MINOR EXCEP-

LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 02 HONG K 01370 01 OF 02 061007Z

TIONS, IN ALL YEARS UNTIL 1974-75 CURRENT REVENUE HAD

COVERED BOTH CURRENT AND CAPITAL EXPENDITURES. OVER THE YEARS, THE HKG HAS ACCUMULATED BUDGETARY SURPLUSES WHICH IT CALLS "THE FISCAL RESERVES." THEY ARE INVESTED IN SECURITIES IN THE U.K. (40 PERCENT), THE U.S. (40 PERCENT) AND ELSEWHERE. THEY YIELD APPROXIMATELY \$60 MILLION PER YEAR IN INCOME TO THE HKG. (ALL FIGURES IN THIS MESSAGE ARE IN U.S. \$)

RECENTLY, HOWEVER, THE SURPLUSES HAVE BEEN REPLACED BY DEFICITS. REVENUES DEPEND UPON THE STATE OF THE HONG KONG ECONOMY, WHICH IN TURN IS DICTATED BY THE LEVEL OF WORLD TRADE. THUS, THEY ARE SUBJECT TO WIDE FLUCTUATIONS, AND HAVE NOT GROWN AT AN EVEN RATE. HKG EXPENDITURES ON THE OTHER HAND, HAVE TENDED TO INCREASE AT FAIRLY CONSISTENT RATES. CONTINUED FAST POPULATION GROWTH AND DEMANDS FOR INCREASED SOCIAL SERVICES ARE LIKELY TO EXERT FURTHER UPWARD PRESSURE ON EXPENDITURES.

WHILE HONG KONG'S BUDGET IS NOT AS SOUND AS IN PRIOR YEARS, IT IS STILL VERY PRUDENTLY MANAGED BY WORLD STANDARDS. CURRENT EXPENDITURES AMOUNT TO ONLY 87 PERCENT OF CURRENT REVENUES. THE DEFICIT INCURRED BY THE HKG, THEREFORE, REPRESENTS A DEFICIT ONLY IN THE CAPITAL ACCOUNT.

2. THE 1975-76 BUDGET SPEECH

IN HIS SPEECH LAST FEBRUARY, THE FINANCIAL SECRETARY LAID OUT HIS COURSE OF ACTION DESIGNED TO COMBAT THE DEFICIT. HADDON-CAVE WAS AWARE OF THREE OPTIONS: 1) RAISE TAXES 2) CUT SPENDING 3) PURSUE DEBT FINANCING. RATHER THAN RELY ON ANY ONE OF THESE OPTIONS, HE DECIDED TO USE A COMBINATION OF THE THREE. FURTHER BACKGROUND IS AVAILABLE IN REFTEL.

WHILE AN INCREASE IN TAXATION REPRESENTS A SIGNIFICANT DEPARTURE FROM HONG KONG'S TRADITIONAL ORIENTATION, FINANCING A BUDGETARY DEFICIT IS ALSO A RADICAL CHANGE.

3. FINANCING THE DEFICIT

LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 03 HONG K 01370 01 OF 02 061007Z

THE FINAL DEFICIT FOR 1975-UY APPEARS TO BE CLOSE TO HADDON-CAVE'S PROJECTION OF HK\$68 MILLION. THE FINANCING ARRANGEMENTS FOR THIS DEFICIT INCORPORATED FOREIGN PRIVATE PLACEMENTS AND DOMESTIC BOND ISSUE.

OFFSHORE FINANCING CONSISTED OF APPROXIMATELY \$60 MILLION IN EUROPEAN AND U.K. PRIVATE PLACEMENTS. THE TERM OF THE LOAN IS FIVE YEARS, AND THE RATES ARE 1.25 PERCENT

ABOVE THE LONDON INTER-BANK RATE FOR THE FIRST 3 YEARS,
AND 1.375 PERCENT ABOVE THE REMAINING 2 YEARS.

THE FIRST SIGNIFICANT ENTRANCE INTO THE DOMESTIC BOND
MARKET BY THE HKG OCCURRED ON NOVEMBER 25, 1975. ON THAT
DATE, THE HKG FLOATED A BOND ISSUE FOR \$50 MILLION WITH A
FIVE YEAR MATURITY AND 6.5 PERCENT COUPON. THE ISSUE
PRICE WAS 99 FOR A YIELD TO MATURITY OF 6.85 PERCENT. BIDS
RANGED FROM 98 TO 105, WITH A TOTAL OF \$43.8 MILLION IN
BIDS ABOVE THE ISSUE PRICE. THE GOVERNMENT TENDER BROUGHT
IN AN AVALANCHE OF OVER \$90 MILLION IN BIDS.

NEVERTHELESS, THERE ARE LIMITS TO THE AMOUNT OF DEBT
WHICH HONG KONG CAN ASSUME, ACCORDING TO HADDON-CAVE, AS
NOTED IN REFTTEL.

4. THE FINANCIAL SECRETARY'S OCTOBER, 1975 SPEECH

IN A SPEECH ENTITLED THE FUTURE FOR HONG KONG, HADDON-
CAVE DISCUSSED THE NATURE OF HONG KONG'S ECONOMY AND ITS
PROBABLE COURSE OVER THE NEXT TEN YEARS.

THROUGHOUT THE SPEECH HADDON-CAVE STRESSED HONG KONG'S
VIRTUAL RESOURCELESSNESS AND ITS RESULTINGLY HEAVY DEPENDENCE
ON EXTERNAL TRADE.

IN ORDER TO REMAIN SUCCESSFUL IN THE CONTEXT OF
WORLD TRADE, HE SAID, CAPITAL AND LABOR MUST CONTINUE TO
BE MOBILE AND RESPONSIVE TO CHANGE. IT IS HADDON-CAVE'S
FIRM CONVICTION THAT TO DEVOTE AN EVER LARGER PERCENTAGE
OF G.D.P. TO THE GOVERNMENT SECTOR WOULD HINDER HONG KONG'S
ECONOMIC GROWTH. BY DOING SO, RESOURCES WOULD BE USED LESS
PRODUCTIVELY THAN IN THE PRIVATE SECTOR. HE STATED "THIS
LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 04 HONG K 01370 01 OF 02 061007Z

WOULD LOWER THE GROWTH RATE OF THE ECONOMY WHICH COULD,
IN TURN, LEAD TO HIGHER INTERNAL COSTS AND PRICES,
BALANCES OF PAYMENTS DIFFICULTIES AND THUS A SLOWER
GROWTH RATE STILL; AND THIS PROCESS WOULD BEGIN THE SOONER,
THE LOWER THE GROWTH RATE OF THE ECONOMY AT THE TIME."

HADDON-CAVE CONSIDERS IT IMPORTANT THAT THE RATION OF
TOTAL GOVERNMENT EXPENDITURES TO G.D.P. SHOULD BE HELD
CLOSE TO THE HISTORICAL EXPERIENCE OF 18 PERCENT. HE NOTED
THAT A RISE IN THIS RATION TO 20 PERCENT "...
REQUIRE MORE RADICAL CHANGES TO OUR FISCAL SYSTEM. ..."

LIMITED OFFICIAL USE

NNN

LIMITED OFFICIAL USE

PAGE 01 HONG K 01370 02 OF 02 061010Z

11

ACTION EA-09

INFO OCT-01 ISO-00 SP-02 AID-05 EB-07 NSC-05 CIEP-01

TRSE-00 SS-15 STR-04 OMB-01 CEA-01 CIAE-00 COME-00

FRB-03 INR-07 NSAE-00 USIA-06 XMB-02 OPIC-03 LAB-04

SIL-01 PA-01 PRS-01 AGR-05 /084 W

----- 083305

R 060748Z FEB 76

FM AMCONSUL HONG KONG

TO SECSTATE WASHDC 9021

LIMITED OFFICIAL USE SECTION 2 OF 2 HONG KONG 1370

5. FORECAST FOR 1976-77 BUDGET

ALTHOUGH THE 1976-77 BUDGET SPEECH WILL NOT BE DELIVERED UNTIL FEBRUARY 24, THERE IS SPECULATION IN HONG KONG'S FINANCIAL CIRCLES THAT A NUMBER OF MAJOR CHANGES MAY BE FORTHCOMING.

HISTORICALLY, THE HKG'S REVENUES AS A PERCENTAGE OF G.D.P. WERE SLIGHTLY LOWER THAN HADDON-CAVE'S TARGETED EXPENDITURE TO G.D.P. RATION. THIS, OF COURSE, WOULD LEAD TO PERPETUAL DEFICITS.

ACCORDING TO AN IN-HOUSE REPORT PREPARED BY A MAJOR U.S. BANK HERE, REVENUES HAVE HISTORICALLY AMOUNTED TO APPROXIMATELY 17 PERCENT OF G.D.P. EXPENDITURES ON THE OTHER HAND, ACCORDING TO HADDON-CAVE, SHOULD BE AT LEAST 18 PERCENT AND MIGHT GO AS HIGH AS 20 PERCENT. THE STUDY ASSUMES 18.5 PERCENT AS REALISTIC. GIVEN THESE PROJECTIONS HONG KONG WILL BE FORCED TO FINANCE A DEFICIT OF ABOUT 1.5 PERCENT OF G.D.P. INDEFINITELY.

NUMEROUS MEMBERS OF THE FINANCIAL COMMUNITY, BOTH WITHIN THE GOVERNMENT AND WITHOUT, FEEL THAT CONTINUING DEFICITS

LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 02 HONG K 01370 02 OF 02 061010Z

IN THE HONG KONG BUDGET WILL SERIOUSLY IMPAIR THE HKG ABILITY TO BORROW. THIS IS DUE TO REASONS WHICH HADDON-CAVE HAS NOTED REGARDING THE VULNERABLE NATURE OF HONG KONG'S ECONOMY. TO INCUR SUBSTANTIAL FIXED CHARGES BACKED BY VOLATILE REVENUES IS REGARDED AS RISKY, AND COULD CONCEIVABLY BOOST THE HKG'S BORROWING COSTS CONSIDERABLY. THE HKG WILL PROBABLY TRY EITHER TO LIMIT THE DEFICITS OR PERHAPS EVEN TO ELIMINATE THEM ALTOGETHER.

GIVEN THAT THE EXPENDITURE TO G.D.P. RATIO IS NOT LIKELY TO DROP BELOW 18.5 PERCENT AND CERTAINLY NOT BELOW 18 PERCENT, THE REVENUE TO G.D.P. RATIO MUST RISE.

1975 HAS ALREADY SEEN MOVES IN THIS DIRECTION WITH THE ELIMINATION OF THE COMMONWEALTH PREFERENCE IN THE FIRST REGISTRATION TAX ON AUTOMOBILES, AND INCREASES IN IMPORT DUTIES ON LIQUOR AND TOBACCO. OTHER INCREASES MAY OCCUR IN ENTERTAINMENT TAXES, AND BETTING TAXES.

ANOTHER STRONG POSSIBILITY IS THAT OF A FURTHER CORPORATE PROFITS TAX INCREASE. ACCORDING TO THE 1975-76 BUDGET STATEMENT, THE 10 PERCENT (15 TO 16.5 PERCENT) INCREASE IN PROFITS TAX IN 1975 IS DUE TO BE REPLACED IN THE 1976-77 BUDGET BY 3.5 PERCENT WITHHOLDING TAX ON DIVIDENDS.

(DIVIDENDS ARE NOT NOW SUBJECT TO HONG KONG PERSONAL INCOME TAX.) IT IS ALSO POSSIBLE THAT THE WITHHOLDING TAX WILL BE INSTITUTED WITH AN ADDITIONAL "ONE YEAR" INCREASE IN THE PROFITS TAX RATE TO AN EFFECTIVE RATE OF 18 OR 18.5 PERCENT.

THE RATES OF PERSONAL TAXATION WERE UNTOUCHED BY THE 1975-76 BUDGET AND REMAIN AT 15 PERCENT. THE FINANCIAL SECRETARY MAY CHOOSE TO INCREASE THESE TAXES.

EVEN IF TAXES ARE RAISED, HONG KONG RATES WILL STILL REMAIN THE LOWEST IN ASIA, AND AMONG THE LOWEST IN THE WORLD. BY DOING SO, HONG KONG COULD PRESERVE ITS TRADITION OF FINANCIAL INTEGRITY AND STILL REMAIN HIGHLY ATTRACTIVE FOR FOREIGN INVESTMENT.

CROSS
LIMITED OFFICIAL USE

LIMITED OFFICIAL USE

PAGE 03 HONG K 01370 02 OF 02 061010Z

LIMITED OFFICIAL USE

NNN

Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: GOVERNMENT BUDGET, PROGRAMS (PROJECTS), ECONOMIC PROGRAMS
Control Number: n/a
Copy: SINGLE
Draft Date: 06 FEB 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: morefirh
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976HONGK01370
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D760045-0996
From: HONG KONG
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19760275/aaaacnxx.tel
Line Count: 272
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EA
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 5
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: 76 HONG KONG 2098
Review Action: RELEASED, APPROVED
Review Authority: morefirh
Review Comment: n/a
Review Content Flags:
Review Date: 20 MAY 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <20 MAY 2004 by ellisoob>; APPROVED <01 JUN 2004 by morefirh>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: PROJECTIONS FOR 1976-1977 HONG KONG BUDGET
TAGS: EFIN, HK
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006